No. 11625.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

ESTATE OF BELLE ALICE HAMBURGER NATHAN, EVELYN HAMBURGER, EXECUTRIX,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S OPENING BṚIEF.

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Estate of Belle Alice Hamburger Nathan, Evelyn Hamburger, Executrix,

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vs.

Commissioner of Internal Revenue,

Respondent.

PETITIONER'S OPENING BRIEF.

Jurisdiction.

This petition has been filed to review a decision of The Tax Court of the United States involving the federal estate tax liability of Petitioner.

Notice of deficiency was mailed to Petitioner on December 27, 1943 [R. 10], and the petition for redetermination of the deficiency was filed with The Tax Court on February 9, 1944. [R. 5-17.] The petition was filed pursuant to Section 1012(a) of the Internal Revenue Code.

The Memorandum Findings of Fact and Opinion of The Tax Court, which is not reported, was entered on July 17, 1946 [R. 36-59], and an order amending said Memorandum Findings of Fact and opinion was entered July

22, 1946. [R. 59-60.] On August 15, 1946, Petitioner filed motions for rehearing, for reconsideration, and for review by the full Tax Court, all of which were denied on August 19 and 20, 1946. [R. 60-67.] The decision of The Tax Court was entered on December 31, 1946. [R. 67-68.] Petition for review was filed and notice thereof served upon counsel for Respondent on March 25, 1947. [R. 477-492.]

The federal estate tax return (form 706) for the above named estate was filed with the Collector of Internal Revenue for the Sixth District of California, at Los Angeles. [R. 36 and 375.] The petition for review was filed pursuant to Section 1142 and jurisdiction is invoked under Section 1141 of the Internal Revenue Code.

Questions Presented.

1. Whether The Tax Court erred as a matter of law in valuing the stocks of Hamburger Realty Company and A. Hamburger & Sons at $3900.00 and $1000.00 per share, respectively, in any of the following particulars: a lack of any substantial evidence or evidence legally sufficient to sustain its findings of value; a failure to consider relevant factors, such as: past and prospective earnings, dividend paying capacity, lack of marketability, lack of management (present and prospective), failure to consider that the number of shares of stock of each corporation involved herein constitutes a minority interest, anticipated income tax burdens, economic conditions prevailing on the basic date and all other relevant factors; failure to assume the existence of hypothetical willing purchasers and sellers; an arbitrary and unreasonable disregard of the testimony of expert witnesses; failure to

base its conclusions (opinion) and decision on its findings of fact.

2. Whether The Tax Court's conclusions (Opinion) and decision are contrary to its Findings of Fact.

3. Whether The Tax Court's conclusions (Opinion) and decision are contrary to law.

4. Whether The Tax Court abused its discretion in denying Petitioner's Motions for Rehearing, for Reconsideration and for Review by the Full Court.

Statutes and Regulations Involved.

Internal Revenue Code, Section 811:

> "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States—
>
> (a) To the extent of the interest therein of the decedent at the time of his death;
>
> "(j) If the executor so elects upon his return (if filed within the time prescribed by law or prescribed by the Commissioner in pursuance of law), the value of the gross estate shall be determined by valuing all the property included therein on the date of the decedent's death as of the date one year after the decedent's death, . . ."

Treasury Regulations 105; Sec. 81.10:

> "(a) General.—The value of every item of property includible in the gross estate is the fair market value thereof . . . The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell. . . .
>
> * * * * * * * *

"(c) Stocks and Bonds.—The value of stocks and bonds, within the meaning of the Internal Revenue Code, is the fair market value per share or bond on the applicable valuation date.

"If actual sales or *bona fide* bid and asked prices are not available, then, . . . in the case of shares of stock, upon the basis of the company's net worth, earning power, dividend-paying capacity, and all other relevant factors having a bearing upon the value of the stock . . ."

Statement.

INTRODUCTORY.

The Tax Court was called upon to determine the fair market value of shares of stock of two corporations, Hamburger Realty Company and A. Hamburger & Sons, Inc.

Belle Alice Hamburger Nathan died on October 13, 1940. The executors of her Last Will and Testament elected to have the assets of her estate valued on the optional date of October 13, 1941, as authorized by Section 811(j) of the Internal Revenue Code. The basic date is therefore October 13, 1941. The Federal Estate Tax Return, Form 706, was duly filed with the Collector of Internal Revenue, Sixth District of California, and the tax shown thereon to be due was paid concurrently therewith. [R. 36, 374 and 375.]

Among the assets owned by the decedent at the time of her death were 425.817 shares of stock of A. Hamburger & Sons, Inc., and 104.167 shares of stock of Hamburger Realty Company. In the Federal Estate Tax Return decedent's shares of stock in A. Hamburger & Sons, Inc. were valued at $983.35 per share and decedent's

shares of stock in Hamburger Realty Company were valued at $2113.55 per share. [R. 37.] Respondent in his notice of deficiency determined that said shares of stock had values of $1200.00 and $4850.00 per share, respectively. [R. 37.] Respondent subsequently reduced his determination of the value of said shares of stock to $1000.00 and $3900.00 per share, respectively. [R. 37.] Petitioners below filed an amended petition to conform to proof, wherein said shares of stock were valued at $300.00 and $1300.00 per share, respectively. [R. 20-33 and 37.] The Tax Court found the value of said shares of stock to be $1000.00 and $3900.00 per share, respectively. [R. 53.]

The stock of each of said corporations was owned by members of the Hamburger family and each of said corporations is a closed family corporation. No shares of stock of either of said corporations have ever been sold. [R. 39.]

On the basic date, the president, general and executive manager of said corporations was David A. Hamburger, aged 84 years; the vice-president of said corporations was Evelyn Hamburger, aged 72 years; the secretary-treasurer of said corporations was P. L. Nathan, aged 76 years, and Jennie H. Marx was 81 years of age. [R. 39.]

For several years prior to the basic date the said David A. Hamburger had been ill and almost continuously confined to his bed and the said P. L. Nathan had been in poor physical condition and showing signs of senility. Neither Evelyn Hamburger nor Jennie H. Marx had any business experience prior to the basic date. None of the children had any business experience. [R. 51.]

The management on the basic date had not trained nor attempted to train any younger people to take over the management or operation of either of said corporations. [R. 52.]

For many years prior to and subsequent to the basic date there were severe inharmonious relations existing between the stockholders and directors of each of said corporations, which seriously affected adversely the formation of any business or financial or investment policy of either corporation, to the end that such policies remained in *status quo* and stagnated. Each of the individual stockholders had his or her own separate attorney advising him or her in connection with the affairs of said corporations. [R. 52.]

The shares of stock of each of said corporations on the basic date were not attractive to banks as security for a loan. [R. 52.]

The stockholder members of the Hamburger family, by reason of being stockholders, had advantages such as borrowing money at a low rate of interest from the corporations, which they could not have borrowed from other sources on the same collateral. This advantage would not necessarily have been available to the purchaser of the minority interests in the said corporations. [R. 52-53.]

The Stock of A. Hamburger & Sons, Inc.

A. Hamburger & Sons, Inc., was a California corporation. It had issued and outstanding 3774.183 shares of common stock of a par value of $1000.00 each. [R. 37.]

On the basic date the stock was owned as follows: 425.817 shares by petitioner; 425.817 shares by Evelyn Hamburger; 425.817 shares by Jennie H. Marx or by a Trust created by her; 1248.366 shares by David A. Hamburger Corporation; 1248.366 shares by David A. Hamburger as Trustee of the Estate of M. A. Hamburger, deceased. [R. 38.]

A. Hamburger & Sons, Inc., owned 29 parcels of real estate, U. S. Treasury Bonds and Certificates, Mortgages and Trust Deeds, other bonds and stocks, 104.167 shares of stock of Hamburger Realty Company, and indebtedness due from affiliated corporation and from officers and stockholders. It had liabilities of $555,116.55. [R. 43-47.]

The parties stipulated the fair market value on the basic date of all assets and liabilities of A. Hamburger, except its 104.167 shares of stock of Hamburger Realty Company (the value of which was to be determined by The Tax Court and inserted in the balance sheet). [R. 374, 376, 385-389 [Ex. 4].] The Tax Court found the value of the assets and liabilities as stipulated and determined the value of the Hamburger Realty Company stock. [R. 43-47.]

The total fair market value of the assets was $4,-436,883.88 and the total liabilities were $555,116.55, leaving a net worth of $3,881,767.33 (using the value found by The Tax Court for the Hamburger Realty Company stock). [R. 47.] Dividing the net worth by the 3,774.183 shares results in a net worth per share of $1028.50. The Tax Court determined that the fair market value of the A. Hamburger & Sons, Inc., stock was $1,000.00 per share and would have determined "a some-

what larger valuation" had the respondent not asked for a value of $1,000.00 per share. [R. 59-60.]

The indebtednesses due from stockholders arose out of legal complications in a dispute between members of the Hamburger family involving a contest of the Will of Moses Hamburger, who died sometime prior to 1935. [R. 79, 80, 83, 93.] Each member of the family was represented by a different attorney, who, between them, finally settled the dispute. [R. 81.]

The parties stipulated the earnings, expenses, federal income taxes, and net income after taxes, of A. Hamburger & Sons, Inc., for the years 1936 to 1943, both inclusive, and the dividends paid during those years. [R. 374-376, 390-391, 48-50.] A comparison of the dividends paid and the net income after provision for federal income taxes shows that all of the net income was paid out as dividends. Indeed, the stockholders anticipated the earnings of the company and borrowed the earnings during the current year against the declaration and payment of dividends. [R. 52.] The total net income available for dividends for said years was $2,061,137.78 and total dividends paid for said years was $2,292,606.59. The average earnings per share for that period were $68.26. The average dividends paid per share for said period were $75.93. For the year 1941 the corresponding figure was $66.60.

The principal source of income to A. Hamburger & Sons, Inc., was the May Co. lease. A. Hamburger & Sons, Inc., leased from Hamburger Realty Co. property situated at Broadway, Eighth and Hill Streets in Los Angeles, California, which lease terminated on December 31, 1942. The annual rental was $250,000.00. On

March 30, 1923 A. Hamburger & Sons, Inc., subleased said property to the May Department Stores Company for a term of years, terminating December 31, 1942 for a total rental of $10,355,625.60 payable $43,148.44 per month. The annual rental was $517,781.28 which, after deducting the rental payable by A. Hamburger & Sons, Inc., produced an annual income of $267,781.28. [R. 50.] Thus on the basic date it was known that the past earnings would constitute no basis for determining the future earnings. This is borne out by the earnings for the year 1943, when net earnings after taxes amounted to $74,637.23, or approximately $20.00 per share. [R. 49.] The evidence thus established a reasonably reliable estimate of prospective earnings.

Substantial increases in costs, particularly in federal income taxes, were seen as inevitable on October 13, 1941. [R. 135.] The Excess Profits Tax Act and the Defense Tax Act had been enacted in 1940 and the Excess Profits Tax Act had been amended in 1941. Corporation tax rates increased from a high of 24 per cent in 1940 to a high of 31 per cent in 1941, and excess profits tax rates had been increased 10 per cent in each bracket in 1941 over 1940.

The uncontradicted and unquestioned testimony of witnesses established the fact that representative stocks were selling in a range of prices which, on dividends paid, yielded from 5.61 per cent to 10 per cent or from 10 to about 18 times dividends. The yield on Dow-Jones average on industrial stock was about 6.2 per cent on the basic date and the stock was selling at an average of 10.5 times earnings. [R. 130-131, 152, 175, 176.] But in determining the value of the stock of A. Hamburger

& Sons, Inc., past average earnings had to be modified to reflect the loss of the May Co. rentals fourteen months subsequent to the basic date.

Mr. Eitner and Mr. Walker testified that after the loss of the May Co. lease, expected future earnings and dividends would be about $25.00 per share and capitalized that figure at ten and seven times earnings, respectively. They then each added to such figures the present worth as of the basic date of the dividends to be received for the years 1941 and 1942 based on the actual earnings for the year 1941, which included the May Co. lease rentals. They thus arrived at values of $337.50 and $297.66 per share, respectively. [R. 148-152, 199-201.]

The atmosphere of the stock market was one of uncertainty and fear, caused by unfavorable developments in Europe, concern of the possible entry of the United States in the war, and the certainty of higher taxes. The stock market was on a downward trend. [R. 143, 176.] Investors were demanding liquidity. The stocks of leading investment trusts were selling on the stock exchange from 25 per cent to 34 per cent below the fair market value of their net worth. Real estate securities sold in Los Angeles, California in 1941 from 50 to 80 per cent of the fair market value of their net worth and for six times earnings. [R. 159, 219.]

Respondent produced one witness who testified to a value of $1029.29, arrived at by dividing the net worth of the company by the number of outstanding shares. He then rounded the figure to $1000.00, because stocks such as this sell in round figures. [R. 263, 269, 285, 286.] The Tax Court found a value of $1000.00 solely on asset value. [R. 58-59.]

The Stocks of Hamburger Realty Company.

Hamburger Realty Company was a California corporation having issued and outstanding 1000 shares of common stock of $1000.00 par value each. On the basic date the stock was owned as follows: 104.167 shares by the Estate of Belle A. H. Nathan; 104.167 shares by Evelyn Hamburger; 104.167 shares by Jennie H. Marx, or by a Trust created by her; 291.666 shares by David A. Hamburger Corporation; and 291.666 shares by David A. Hamburger as Trustee of the Estate of M. A. Hamburger, deceased. [R. 38.]

Its assets consisted of approximately $160,000.00 of current assets; $4,393,300.00 real estate, of which the property situated on Broadway, Eighth, and Hill Streets in Los Angeles, California, and leased to A. Hamburger & Sons, Inc., and May Co. represented $4,000,000.00; and $6900.00 of other assets. It had total liabilities of $630,478.63. The parties stipulated the fair market value of all the assets and the liabilities on the basic date. [R. 374, 375, 381-382 [Ex. 1].] The net worth of the company was $3,927,153.64 [R. 51], which, divided by the 1000 shares of stock outstanding, resulted in a net worth per share of $3927.15. The Tax Court determined a fair market value of the Hamburger Realty Company stock was $3900.00 per share and would have determined "a somewhat larger valuation" had the respondent not asked for a value of $3900.00 per share. [R. 59-60.] Mr. Allen, a witness called by respondent, rounded out the asset value of $3927.15 to $3900.00, because personal assets sell in round figures. [R. 263, 274-275.]

The receipts, expenses, federal income taxes, and net income after taxes and dividends paid, were stipulated by

the parties and so found by The Tax Court for each year beginning 1936 through 1943. [R. 383-384, 41-43.] A comparison of the dividends paid and the net income after provisions for federal taxes shows that all such net income was paid out as dividends. The total net income available for dividends for said years was $1,257,262.43 and total dividends paid for said years was $1,325,104.51. The average earnings per share for said period was $157.16. The average dividends paid per share for said period was $165.64. For the year 1941 the corresponding figures were $151.44 and $149.61.

The principal source of income to Hamburger Realty Company was the rental income of $250,000.00 a year from A. Hamburger & Sons, Inc., on the lease covering the property on Broadway, Eighth and Hill Streets. The company's total income from other sources ranged from $22,540.06 to $44,825.72 during the period 1936 to 1941. [R. 383-384.] However, on the basic date, it was known that the lease to A. Hamburger & Sons, Inc., would terminate on December 31, 1942 and the lease to the May Co., which had been executed in 1923, would come into force and thus the company's income from the Broadway, Eighth and Hill Street property would be increased to $300,000.00 a year. [R. 50.] However, as was stated in relation to A. Hamburger & Sons, Inc., it was equally known that costs of operation and federal income taxes would increase and that only a relatively small amount of the additional $50,000.00 of income would be available to the company. Actually, a comparison of the 1943 and

1941 profit and loss statements shows that while the company's gross income increased $46,000.00 in 1943 over 1941, the net income after taxes was $21,000.00 less in 1943 than in 1941, due to increases in expenses and in federal income taxes, which latter also increased $46,000.00 in 1943 over 1941. [R. 42.] Consequently, a buyer in 1941 could not have reasonably expected the company's net income after taxes to have been greatly different than the previous five year average.

As shown above, representative securities were selling at about ten times earnings and yielding between six per cent and ten per cent.

Mr. Eitner testified that the fair market value of the Hamburger Realty Company stock would be eleven times earnings to yield nine per cent, and Mr. Walker testified a factor of ten times earnings and a yield of ten per cent would produce the fair market value of said stock. [R. 132-133, 176, 177.] This produced a fair market value of $2000.00 and $1750.00, respectively. Each increased the average earnings as of 1941 by the anticipated increase in earnings from the increased May Co. rental beginning in 1943. This estimate of the increase after taxes was $30.00 per share, so that Mr. Eitner anticipated earnings and dividends to be $180.00 per share and Mr. Walker anticipated earnings and dividends to be $175.00 per share. [R. 131-132, 176.]

The facts relating to the condition of the stock market and world conditions stated above are of equal effect on the Hamburger Realty Company stock.

Specifications of Error.

The Tax Court of the United States erred as a matter of law:

1. In determining and deciding that the per share fair market value of the stocks in question was a sum equivalent to the value of its net assets divided by the number of its outstanding shares.

2. When determining the fair market value of the stocks in question, it disregarded factors of valuation required by law and by Respondent's regulations 105 (Sec. 81.10) to be considered, such as the company's earning power, dividend-paying capacity, marketability of the stocks, testimony of expert witnesses, status of management, present and future, comparison with other securities, the fact that the interest here to be valued is a minority interest, the trend of the market and economic conditions, income tax burdens and all other relevant factors, including the views of the buyer as well as the seller, as required by the definition of "fair market value."

3. In that there was no substantial evidence or evidence legally sufficient to sustain its finding of value for the stocks involved herein.

4. In determining and deciding the fair market value of the stocks here involved contrary to law and its findings of fact.

5. In denying petitioner's Motions for Rehearing, for Reconsideration, and for Review by the Full Court.

Summary of Argument.

Findings of value by The Tax Court must be based upon competent, relevant, and material evidence. The Tax Court decisions must be reversed if they are "not in accordance with law." (Section 1141(c)(1), Internal Revenue Code.) The present decision is not in accordance with law, because The Tax Court erred as a matter of law in the following respects:

1. It determined the value of the stocks here involved solely on net worth.

2. It failed to consider and disregarded the various factors required by the adjudicated cases and by the Treasury Regulations to be considered, such as earnings, dividend-paying capacity, marketability, expert testimony, income tax burdens and expenses, management, comparisons with other securities, the fact that the interest here involved is a minority interest, and the trend of the market and economic conditions.

ARGUMENT.

I.

The Court Erred in Determining the Value of the Stocks Involved Solely on Net Worth.

There can be no question that the Court based its determination of the fair market value of the two stocks here involved solely on the fair market value of the respective corporation's net worth. The Court states:

> ". . . for existing purposes the fair market value of the assets is the only remaining available factor that can be intelligently used in arriving at this valuation." [R. 58.]

The Court then cites *Estate of Henry E. Huntington, Deceased,* 36 B. T. A. 698 and *Bank of California v. Commissioner,* 133 F. (2d) 428 and quoted the holdings therein to the effect that the stocks therein involved were valued solely on the basis of the net worth of the corporations. [R. 58-59.] The Court then states,

> "On the basis of the above precedents we would be inclined to find a somewhat larger valuation than is contended for by respondent."

The Court then states it will approve the values of $3-900.00 and $1,000.00 per share of Hamburger Realty Company and A. Hamburger & Sons, Inc., respectively, as requested by Respondent. [R. 59.]

The net worth values for the two companies was $3,-927.15 and $1,029.29, respectively. Obviously, we submit, the "somewhat larger valuation" referred to by the

Court was the $27.15 and $29.29 to bring the values determined up to the net worth value.

This is the method used by Mr. Allen, a witness called by respondent. [R. 263, 269, 274-275, 285-286.]

This Court and many others have held that it is reversible error to consider net worth alone. In *Bank of California v. Commissioner, supra,* one of the cases relied on by The Tax Court, after quoting regulations identical with those involved here, this Court stated at page 430:

> "Oakburn was a close corporation. Therefore, in determining the fair market value of Oakburn stock at the time of decedent's death, *the Board was required to consider the factors mentioned in article 13—net worth, earning power, dividend-paying capacity, and all other relevant factors*—in so far as the evidence disclosed them . . ." (Emphasis added.)

This Court then examined the evidence and concluded that the evidence before the Board did not disclose the referred to factors and for this reason affirmed the Board.

In *Laird v. Commissioner,* 3 Cir., 85 F. (2d) 598, *Weber v. Rasquin,* 2 Cir., 101 F. (2d) 62, *Worcester County Trust Co. v. Commissioner,* 1 Cir., 134 F. (2d) 578, and *Commissioner v. McCann,* 2 Cir., 146 F. (2d) 385, the Circuit Courts reversed the Board of Tax Appeals for its failure to give effect to the same requirements of the regulations.

II.

The Court Erred in Disregarding Factors of Valuation Required by Court Decisions and Respondent's Regulations to be Considered.

The Opinion of The Tax Court opens with a statement that "Petitioners contend that the value of the stocks of these two corporations must be determined by taking into account the earnings of the corporation, the dividends paid, and payable, marketability of the stock, the net worth of the company, the condition of the management of the company, a comparison of these stocks with other similar securities, market trends, conditions and restrictions affecting said stocks, the position of minority interests in said corporations and other similar facts . . . They also take the position that the fair market value of the stocks in this case is controlled by the rule expounded by many decisions and set forth in Section 81.10 of Treasury Regulations 105:

> "The fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell." [R. 54.]

The second paragraph of the Opinion immediately following the above quotation states:

> "The respondent contends that when all of the peculiar facts in this case are considered, *all elements which would ordinarily be weighed in arriving at the value of the stock,* except the earnings of the corporation and the appraised value of their tangible assets, *are of little use.*" [R. 54.] (Emphasis added.)

The very next sentence of the Opinion is as follows:

> "In *resolving these two positions,* certain basic facts impress us as controlling." [R. 54-55.] (Emphasis added.)

The word "weigh" as used in the Court's Opinion means "to consider or examine for the purpose of forming an opinion or coming to a conclusion"; "to consider as worthy of notice"; "to be considered as important"; "to judge, estimate, consider."

Webster's New International Dictionary—"Weigh."

Thus, the Court states that it must determine whether it will adhere to petitioner's contentions that all factors affecting value as "expounded in many decisions" and "Sections 81.10 of Treasury Regulation 105" must be considered or whether it will adhere to Respondent's contention that only two of said factors—earnings and asset value—should be considered.

The Court then proceeds to do a most peculiar bit of resolving between the two contentions, by arriving at conclusions diametrically opposed to the evidence and to its findings of fact, for the sole purpose, not of considering the earnings, but to eliminate from Respondent's contention the earnings factor and thus leaving only the asset value upon which to base the value of the stocks in question.

Never again, after reciting Petitioner's contentions, does the Court refer to them; never again does it refer to the "willing buyer and willing seller"; never again does it refer to "the rule expounded by many decisions." On the contrary, its only reference is to matters not sup-

ported by the evidence or its findings of fact (to which we will refer in detail later) to eliminate the earnings factor from consideration.

In resolving the conflict of the Petitioner's and Respondent's contentions in favor of Respondent, the Court committed reversible error, for the rule of valuation is that *all* the above referred to factors must be considered, and it is reversible error to pick out one or two only of said factors and base the value of property in question thereon.

In *Guggenheim v. Helvering* (2 Cir.), 117 F. (2d) 469 at 473 the Court, speaking through Learned Hand, Circuit Judge, said:

> "These values were however only *two* of the factors which entered into the value of the decedent's interest in the 'Old Firm,' and it by no means followed that because they made up all the property of the partnership his interest should be appraised as though he had held outright his aliquot part of the shares and the accounts and could have immediately disposed of them."

And after referring to several other factors which the Board disregarded, the Court reversed the Board because "The Board made no allowance for these factors . . ." (p. 474.)

> *Laird v. Commissioner,* 3 Cir., 857 F. (2d) 598;
>
> *Weber v. Rasquin,* 2 Cir., 101 F. (2d) 62;
>
> *Worcester County Trust Co. v. Commissioner,* 1 Cir., 134 F. (2d) 578;
>
> *Commissioner v. McCann,* 2 Cir., 146 F. (2d) 385.

1. *Earnings and Dividend-paying Capacity.* We shall attempt to demonstrate the truth of our statement above,

that the Court relied on erroneous and unsupported conclusions to eliminate earnings and dividend-paying capacity from consideration.

The Court states: "For many years past A. Hamburger & Sons, Inc., had been operating apparently on the basis of advancing the private economic welfare of its stockholders and officers rather than attempting to increase its own earning capacity." [R. 55.] The Court then refers to $1,920,000.00 of two per cent notes [Exs. C-F, incl., R. 352-374], secured by mortgages or liens on stocks to stockholders and says "The repayment of the note is by installment payments and no interest at all is required, except on overdue installments." [R. 55.] The notes are all substantially in the same form and contain the same provisions. Referring to the notes [Exs. C-F, incl.] the following provision is found in each note: "All unpaid balances of said indebtedness shall bear interest at the rate of two per cent (2%) per annum, payable on March 10, 1939, and annually thereafter." [R. 352, Ex. C; 358, Ex. D; 363, Ex. E; 369, Ex. F.] There is no other reference to interest in any of said notes. The only direct testimony as to interest is that the notes were two per cent notes. [R. 93.]

The only explanation for the Court's erroneous conclusion is that the Court interrupted "unpaid balances" to mean "overdue installments," which, we submit, is a wholly unwarranted interpretation.

The Court then refers to $384,000.00 of open accounts due from stockholders and because it erroneously concluded that no interest was charged on the notes, it concluded that none was charged on the open accounts. [R. 55-56.] It would seem that since the basis of the Court's

presumption is erroneous, its presumption is erroneous, and is contrary to the provisions of Section 1914 of the *Civil Code of Californa,* which provides that a loan of money is presumed to be made upon interest, unless it is otherwise expressly stipulated at the time in writing. In the absence of agreement interest is chargeable by law at the rate of seven per cent. *California Constitution,* Art. XX, Sec. 22, and *Douglas v. Klopper*, 288 Pac. 36, 40.

The Court then states that there were ample bonds on the market in 1940 and 1941 *returning* 4 per cent interest and of extremely high security. [R. 56.] There is not one iota of evidence in the record upon which to base that statement. Not even the securities in A. Hamburger & Sons, Inc., portfolio, to which the Court refers. [R. 56.] The Court has no knowledge of the Los Angeles City High School District bonds, not even the maturity date, and hence it could not compute the interest return. And the United States Treasury bonds, Series 1947-52, would not yield 4 per cent to maturity on their then selling price. (Col. B.) [R. 43.]

These conclusions of the Court constitute the "basic facts" which impress the Court as controlling [R. 54-55], in resolving the contentions of Petitioner and Respondent and lead the Court to the additional conclusion that

> "Under these circumstances it is obvious that little help can be received from considering the dividends paid record of *these corporations* for the reason that *their* dividend paying system was entirely abnormal. Thus, we have *two corporations* with no record of stock sales, a method of business operations unlike any normal corporation, and a system of paying divi-

> dends to stockholders whereby the stockholders profited more from receiving the use of the assets of the corporations to their own individual profit than they would have profited by receiving normal dividends. Under such conditions we do not feel that any system of evaluating this stock which would apply to a normal corporation would be useful here." [R. 56.] (Emphasis added.)

The statements that the "dividend paying system was entirely abnormal" "whereby the stockholders profited more from receiving the use of the assets of the corporation to their own individual profit than they would have profited by receiving normal dividends" are made in the face of the stipulated facts and the Court's own findings showing that *every cent* of net income received by each corporation after payment of federal income tax was paid to the stockholders as dividends each year for the period 1936 to 1943, both inclusive. [R. 41-43; 48-50; 383-384; 390-391.] We submit that whatever abnormality existed in the dividend paying system would be favorable to the stockholders.

It is obvious, we believe, that it is the loans made by A. Hamburger & Sons, Inc., to its stockholders which caused the Court to conclude that the dividend paying policy was abnormal and profited the stockholders more than they would have profited by the payment of normal dividends. This conclusion indicates the superficiality with which the record in this case was examined. (As will be later pointed out, the Judge who decided the case did not try the case and had only the record to guide him.)

A reading of the Court's opinion and the conclusions therein expressed would indicate that the directors and

stockholders were a happy, friendly family group and that the notes given by them were the result of a plan to milk the corporation and were recurrent—all of which is contrary to the evidence and the Court's findings of fact. The directors and stockholders were not friendly but were bitter enemies [R. 52, 80, 106-107]; each had a separate attorney to represent him in connection with the corporation affairs [R. 80-81; 91-92]; the notes were the result of legal disputes between the family members, including a will contest [R. 93], all of which occurred at and after the death of Mose Hamburger and was concluded in connection with the settlement of the will contest and corporate affairs in or about October, 1935 [R. 83, 93]; and from then on the notes have been a frozen transaction [R. 93] and, hence, not recurrent; the notes were a legal complication, not a business complication. [R. 93.]

It must follow, we submit, that the loans were not "a system of paying dividends to stockholders" and the dividend paying policy was not abnormal.

Even if we were to give credence to the Court's conclusions with respect to the notes due A. Hamburger & Sons, Inc., we fail to follow the logic which would make those "facts" applicable to Hamburger Realty Company. There were *no* loans to stockholders made by Hamburger Realty Company. [R. 39-41.] Yet the Court makes the foregoing conclusions applicable to "these corporations" and the "two corporations." [R. 56.]

As an additional reason for refusing to consider the earnings of Hamburger Realty Company, the Court refers to the method used by the parties hereto in arriving at the fair market value of its principal asset—namely, by capitalizing the rentals to be received thereon over the

terms of the May Co. Lease. [R. 58.] This, the Court states, is tantamount to the consideration of the income of the corporation in arriving at the value of the stock of Hamburger Realty Company.

The fallacy of this statement is, we believe, forcibly told in the following language of the Supreme Court of the United States in *Ray Consolidated Copper Company v. U. S.,* 268 U. S. 375 at 377:

> "The capital stock of a corporation, its net assets, and its shares of stock, are *entirely* different things. The value of one bears no *fixed or necessary relation* to the value of the other." (Emphasis added.)

In *Laird v. Commissioner of Internal Revenue,* 85 F. (2d) 598, the Circuit Court for the Third Circuit reversed the Board of Tax Appeals because it valued the assets (securities) of the closed corporations by taking the mean between the high and the low selling prices of the securities to determine the net worth of the two corporations there involved and dividing this by the number of outstanding shares.

See, also:

> *Laird v. Commissioner,* 38 B. T. A. 926 at 942.

That the Court's reasoning is wholly devoid of logic can be demonstrated by a reference to the record. The lease rentals were at the rate of $300,000.00 a year ($25,-000.00 a month). [R. 50.] The *net income* of Hamburger Realty Company after federal income taxes for the year 1941 was only $151,436.75 [R. 42], approximately one-half of the rentals. The asset owned by the corporation was a 100 per cent interest; the stock here to be valued was approximately 10 per cent. Mr. Eitner makes

reference to this difference when questioned on cross-examination. [R. 139-142.]

The refusal to consider the earnings of Hamburger Realty Company in determining the fair market value of 10 per cent of its stock because of the value of an underlying asset and the method used to arrive at its value is, we submit, an error of law.

The Circuit Court of Appeals for the Second Circuit (by Judge August N. Hand) reversed the District Court because it erroneously eliminated earnings from consideration and relied wholly on net worth. The trial judge there, as in the instant case, had discussed and referred to the earnings and dividend-paying capacity of the corporation, and then discarded them and relied wholly on net worth. This the Circuit Court said was error.

Weber v. Rasquin, 101 F. (2d) (2nd Cir.) 61.

That the failure to use earnings and dividend-paying capacity in determining fair market value results in an arbitrary assessment is clearly expressed in *Great Northern Railway Company v. Weeks,* 297 U. S. 135 at 151:

> ". . . when the jurisdiction of the District Court is appropriately invoked, it is its duty to decide upon the merits of the taxpayer's claim that the assessment of his property was arbitrarily made and is grossly excessive. It clearly appears that the Board failed to give reasonable weight to the falling off of petitioner's traffic, gross earnings, operating income, . . . The value of petitioner's property varied with the *profitableness* of its use, present and prospective." (Emphasis added.)

See, also:

Cleveland C. C. & St. Louis Railway v. Backus, 154 U. S. 439 at 445.

2. *Marketability.* The record shows clearly that this stock lacked marketability and liquidity. Mr. Allen, a witness called by the Respondent, testified that he had in mind the other stockholders as purchasers of this stock or an investment trust buying all the property. [R. 279-280, 301.] Mr. Eitner, who has had experience in dealing with stock of closed corporations [R. 122], testified the market would be very limited and Hamburger Realty Company stock here involved would probably have to be sold as a block to a fraternal organization or insurance company [R. 128-130] and that probably the stock of A. Hamburger & Sons, Inc., would have been parcelled in small share lots [R. 150] with consequent expenses of creating a market. Mr. Walker was of like opinion. [R. 177.]

That marketability or liquidity is an important factor in valuations is expressed in *International Harvester Co. v. Kentucky,* 234 U. S. 216 at 222, as follows:

> "Value is the effect in exchange of the relative social desire for compared objects expressed in terms of a common denominator."

The value of any product, including corporate stock, is dependent on the law of supply and demand.

Commissioner of Internal Revenue v. Shattuck, 97 F. (2d) 790, 792;

Williams v. Commissioner, 44 F. (2d) 467.

Notwithstanding the evidence above mentioned and law referred to, The Tax Court refused to consider this factor. This, we submit, was error of law.

3. *Expert Testimony.* We do not contend that The Tax Court is bound to adopt the testimony of expert witnesses, but we do contend that it is not free to arbitrarily ignore such testimony, unless it has independent knowledge or there is other competent evidence in the record. We believe the rule to be as stated by this Court in reversing the Board of Tax Appeals in *Belveridge Oil Co. v. Commissioner* (9 Cir.), 85 F. (2d) 762, 768:

> "It is contended that the Board is not required to follow the testimony of experts, but may disregard their evidence entirely. This statement is too broad. In Boggs v. Buhl v. Commissioner (C. C. A. 3), 34 F. (2d) 859, at page 861, the Court said: 'While the Board may, as a general principle, reject expert testimony and reach a conclusion in accordance with its own klowdedge, experience, and judgment, yet it must have knowledge of and experience with the particular subject under consideration. There is no evidence that the board had any independent and personal knowledge whatever of the business, reputation, and good will of the petitioner. Therefore, it could not set aside or disregard all the positive and affirmative evidence as to the value of the good will, and base its conclusion upon conjecture.' "

Other than referring to the fact that Petitioner introduced the testimony of two experts who gave their opinions as to the value of these stocks after being presented with hypothetical questions in which all of the factors of valuation were included [R. 54], The Tax Court never again refers to their testimony. Since the Court's state-

ment is made in connection with its statement of Petitioner's contention (*supra*) and since the Court resolved the conflicting contentions in favor of Respondent and expressly refused to consider *all* the factors of value [R. 57-58], it is clear that the Court did not consider the testimony of the experts. Neither does it appear anywhere in the record that the Court had independent knowledge, experience, or judgment of the matters testified to by the experts.

Mr. Eitner and Mr. Walker were fully qualified and had made independent research and preparation of their testimony. [R. 120-123, 127, 167-172.]

They testified that the value of the stock here involved of Hamburger Realty Company was $2000.00 and $1750.00 per share, respectively, and that the value of the stock here involved of A. Hamburger & Sons, Inc., was $337.50 and $299.66 per share, respectively. [R. 128, 173, 148, 199.]

We submit that the Court's refusal to consider the expert testimony was arbitrary and constituted reversible error of law.

4. *Income Tax Burdens and Expenses.* Substantial increases in income taxes were regarded as inevitable on the basic date. The Excess Profits Tax Law of 1940 had been amended on March 7, 1941 and The Revenue Act of 1941 had been enacted September 20, 1941. (C. C. H., Vol. 3, par. 1866.03.) Since the Court eliminated earnings from consideration it follows that it did not consider income taxes and expenses which are a drain upon future earnings. This was error, for the Supreme Court in *Galveston Electric Co. v. Galveston,* 258 U. S. 388 at 399,

has held that taxes and expenses must be taken into account:

> ". . . In calculating whether the 5-cent fair will yield a proper return, it is necessary to deduct from gross revenue the expenses and charges; and all taxes which would be payable if a fair return were earned are appropriate deductions. There is no difference in this respect between state and Federal taxes, or between income taxes and others . . ."

Even if we assume that The Tax Court considered earnings in determining the values found, it should have made allowance against the asset value for expenses and income taxes upon liquidation. Not to have done so is error, as held in *Weber v. Rasquin,* 101 F. (2d) 62, at 64:

> "The trial judge did nothing but compute the fractional interest of the decedent as a stockholder in the assets of the corporation without making any deduction for the expenses incidental to liquidation, if it should take place, or for the small earnings of the stock if it did not take place. This, we think, was error."

In determining a value of $3900.00 per share for Hamburger Realty Company, Mr. Allen, a witness called by Respondent, testified that he assumed a purchaser for all the assets of the corporation at the stipulated fair market values thereof. [R. 279.] The book value of those assets was $1,947,164.18 and the fair market value thereof was $4,557,623.27. [R. 41.] If we assume only a 10 per cent selling and liquidating expense, the cost would have reduced the net sales price to about $4,100,000.00, which would mean in excess of $2,000,000.00 profit. If we assume the lowest rate of tax would apply to this

profit, the tax would have been in excess of $600,000.00. (Revenue Act of 1941, Sections 103 and 104.) Thus, the net asset value would be decreased by an amount in excess of $1,000,000.00, or in excess of $1,000.00 per share. Mr. Allen testified that the stockholders would receive the $3,900.00 per share only if there were no charges against the sale. [R. 292-293.]

5. *Other Relevant Factors.* Other relevant factors which The Tax Court refused to consider were the condition of the management of the companies [R. 51-52, 128, 162, 71-76, 93-94, 106-109], comparison with other securities, the fact that the interest here to be valued is a minority interest in such corporation, and the trend of the market and economic conditions. [R. 176.]

Failure to consider these factors constitutes error of law.

> *William v. Commissioner,* 44 F. (2d) 457;
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> *Great Northern Railway Company v. Weeks,* 297 U. S. 135;
>
> *Mathilde B. Cooper,* 41 B. T. A. 114 at 129;
>
> *Helvering & Safe Deposit & Trust Co. of Baltimore,* 95 F. (2d) 806.

> "We think the Board was also in error in failing to consider the Company's prospects for the future as a factor having a bearing on the value of its stock. That is to say, the Board, without explanation, made no mention of certain testimony offered by taxpayers on this subject and it disregarded its own findings to the effect that the sole salaried officer in charge of the Company, although capable, was 'getting along in years,' . . .

"In cases of this sort, where there have been no sales or bid and asked prices, these factors are relevant and should have been considered, not disregarded."

Worcester County Tr. Co. v. Commissioner, 134 F. (2d) (1st Cir.) 578 at 582, in reversing the Board.

Conclusion.

The whole tenor of the opinion in the instant case is a reversal of the traditional attitude of The Tax Court and Board of Tax Appeals—an attitude of humility and willingness to decide difficult questions of fact upon competent evidence introduced before it. This attitude, which has brought the Court to a position of respect, is exemplified in the decision of the Board in the case of *James Couzens,* 11 B. T. A. 1040 at 1060, as follows:

". . . The Board and its members do not have, and are not expected to have, peculiarly expert knowledge upon the value of securities or any other of the multitudinous questions of fact which arise in the vast number of cases before it. It can only decide the issues in any case by giving judicial consideration to the evidence properly in the record. Such evidence is not to be regarded, as expressed by respondent's counsel, as an 'assistance' to the Board in discharging a duty imposed upon it, but as the proof and substantiation by the parties of the positions which they respectively present for adjudication . . . We approach the problem of value, therefore, not as experts with the aid of the parties, but to judge impartially of the issue between conflicting interests, in the light of all the evidence."

As shown, *supra,* the Court's examination of the record was at most superficial, resulting in a series of erroneous conclusions—conclusions contrary to its findings of fact—which led it to the fatal error of refusing to consider any factor of valuation other than net worth.

The Court cites and relies on the case of *Melville Hanscom,* 24 B. T. A. 173, decided long prior to *Laird v. Commissioner,* 85 F. (2d) 598, which reversed the Board for an error of law identical with that made in the *Hanscom* case, and thus tacitly overruling the *Hanscom* case.

The reliance by the Court on the case of *Estate of Henry E. Huntington, Deceased,* 36 B. T. A. 698, was equally erroneous, as the case was tried on the theory that the net worth of the company was the fair market value of the stock. The only question was in relation to discounts in arriving at the net value of the assets. (See pp. 714, 721.)

We have previously shown that this Court's affirmance of the Board in *Bank of California v. Commissioner,* 133 F. (2d) 428 was due only to a failure of proof. This Court cited the regulations and held the Board was required to consider all the factors. (p. 430.)

We believe that the Commission of the errors herein shown to have been made was due in part, at least, to the unfortunate circumstance that this case was decided by a Judge who did not hear the evidence or see the witnesses; by one, in fact, who was not a Judge when the trial was held. This case was tried on October 4th and 5th, 1945 before the Honorable Arthur J. Mellott, an experienced Judge of The Tax Court. On December 8, 1945, Judge Mellott resigned as a Judge of The Tax

Court. Mr. Byron B. Harlan was thereafter appointed and on July 17, 1946 promulgated his Memorandum Findings of Fact and Opinion herein. It appears that Judge Harlan had neither judicial nor tax experience prior to his assuming his duties as a Judge of The Tax Court. (46 C. C. H. Index (Personnel), 18,003-18,004; 46 Prentice-Hall, Vol. 5, par. 70,401, p. 70,165; The Tax Magazine, April, 1946, pp. 393-394.)

Judge Harlan's opinion begins, as we have shown, with the unique doctrine that he must choose between Petitioner's contention that all factors affecting value must be considered and that the definition of fair market value as "expounded by many decisions" and set forth in Respondent's Regulations 105, Sec. 81.10 is controlling and Respondent's contentions that only net worth and earnings must be considered. After making a series of erroneous conclusions contrary to the uncontradicted evidence and stipulated facts and contrary to his own findings of fact, Judge Harlan chooses Respondent's contention that only net worth need be considered. Judge Harlan concludes his opinion with a statement only a little less pointed than that which he announced in the cases of *Victoria L. Cotton, Virginia Caldwell* (1946 Prentice-Hall Tax Court Memorandum Decisions, Par. 46,171, pp. 46-587) only five days after his decision in the instant case to the effect that he "would be very much inclined . . . to accept the Commissioner's finding as our own" were it not for the fact that the Commissioner had abandoned his determination. The Commissioner likewise abandoned his

determination in the instant case and Judge Harlan states [R. 59]: ". . . we would be inclined to find a somewhat larger valuation than is contended for by respondent. However, since the respondent asks for a valuation of $3,900.00 a share for the stock of A. Hamburger & Sons, Inc., and for a value of $1,000.00 a share for Hamburger Realty Company, we will approve that valuation." (See Order [R. 59-60], amending this sentence to apply the $3,900.00 value to Hamburger Realty Company, and the $1,000.00 value to A. Hamburger & Sons, Inc.) We believe that this is a clear statement of abdication of the Court's judicial functions in favor of the Commissioner's whim. That this is erroneous and contrary to law is aptly stated by Justice Learned Hand speaking for Second Circuit in *Guggenheim v. Helvering,* 117 F. (2d) 469 at 474:

> ". . . In appraising property of this kind, whatever courts may say, and however they may seek to disguise what they do, it is impossible to avoid some measure of speculation . . . A judicial duty which is inherently subject to such shortcomings must not stop half way . . . And of all possible appraisals that alone was sure to be wrong which the Board chose; a doctrine so enamored of accuracy that it must abdicate is the most irrational of all. The law is not so helpless; situations again and again present themselves where, after all shifts are exhausted, rather than permit certain injustice, a tribunal will make the best reckoning that the facts admit though fully conscious of its infirmities . . ."

We have not discussed the evidence presented to the Court below tending to establish much lower values than those found by the Court. Rather, we have endeavored to show that the Court committed errors of law and that there was no competent nor relative evidence that could conceivably support the values found by the Court and that the conclusions upon which such values were predicated were erroneous and contrary to its findings of fact and the evidence—in short, that the values found were arbitrary and excessive and that by reason thereof The Tax Court must be reversed.

Helvering v. Taylor, 293 U. S. 507, 555 at 287, 79 L. Ed. 623;

Powers v. Commissioner of Internal Revenue, 312 U. S. 259, 61 S. Ct. 509, 85 L. Ed. 817;

Laird v. Commissioner, supra;

Commissioner v. McCann, supra.

In an effort to have The Tax Court remedy its own errors, Petitioner filed a Motion for a Rehearing (in order that the Judge who was to decide the issues might observe the demeanor of the witnesses and personally hear the evidence) and, in the alternative, Motions for Reconsideration and for Review by the Full Tax Court. These motions were summarily denied. In view of the circumstances, Petitioner believes that the denials were an abuse of the Court's discretion.

This petition for review was filed because of the conviction that the Court committed reversible error of law,

that its conclusions of law and decision were contrary to and not supported by its Findings of Fact, that there was no substantial evidence or evidence legally sufficient to sustain its decision, that the Treasury regulations had been disregarded, that erroneous legal principles had been applied, that its findings of value were arbitrary and excessive, and that its decision was not in accordance with and contrary to law. It is respectfully submitted that the decision should therefore be reversed and the case remanded to The Tax Court with instructions to afford the parties an opportunity for further hearing.

Respectfully submitted,

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